The Problem of Stagflation

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I. Introduction

About a year ago, in March or April 1975, the American economy passed the trough of the sixth postwar recession (not counting the mini-recession of 1966, nor the February-October recession of 1945, the latter being clearly not a cyclical recession but a period of physical changeover from war to peace). The last recession was the longest and most economists would say the severest of the six.(1) The contrast between the last and the earlier recessions was much greater in Europe and Japan than in the United States. This was, in fact, the first truly worldwide recession in the postwar period. But it was a recession and not a depression, if by depression we mean a slump of the order of magnitude of the Great Depressions of the 1930s(1929 ~1933 and 1937~1938) and the (so-called first post-World War I) depression of 1920~1921. However, the 1974~1975 recession had a feature that made it perplexing and disturbing from the theoretical as well as from the policy point of view: it was a highly inflationary recession, a pronounced case of stagflation.

Stagflation and inflationary recession are usually used as interchangeable terms. But it is better to make a distinction. Stagflation can be defined as the coexistence of significant inflation and substantial general unemployment

(1) Geoffrey Moore doubts, however, that it was the severest recession. See his contribution to this volume.

and slack over a considerable period. Inflationary recession is a cyclical recession characterized by rising unemployment and declining output combined with significant inflation. The *rate* of inflation may go up as was the case in the last recession until about the end of 1974, or it may decline as was the case in the last three or four months of the recession in 1975. Stagflation is the wider concept; it covers inflationary recessions as well as those cyclical upswings (or phases of cyclical upswings), like the present one, that are characterized by substantial general unemployment and inflation. The rationale of this definition is, as we shall see presently, that the coexistence of high general unemployment and inflation poses the same problems for economic theory and economic policy in recessions as well as in recoveries.

Stagflation of the present scale and duration is a new phenomenon. It has not happened before that a long and severe recession was accompanied by rapid and for some time even accelerating inflation on a two-digit level; and no earlier cyclical recovery has started with 6 to 8 percent inflation with which the present one started. It is true that faint symptoms of the new disease had been noticed in some of the earlier postwar recessions when prices failed to decline or even continued to rise although at a much lower rate than in the last recession. Morever, it is significant that the cyclical recoveries in the postwar period have shown a tendency to start from successively higher inflation rates. (See Table 2 in Geoffrey Moore's contribution to this volume.)

An earlier episode resembling the current stagflation was the price rise that occurred after the great contraction of 1929～1933 and before the short but very sharp depression of 1937～1938. The price rise was deliberately brought about by the various New Deal measures—NRA, AAA, the Wagner Act and dollar devaluation. But after a while it caused great alarm although, compared with our recent inflation rates, the price rise was modest. It was a case of cost-push inflation and stagflation. Although the expansion from 1933～1937 was fairly rapid and long (fifty months), unemployment was still very high (14.3 percent at the upper turning point of the cycle in 1937). In the following depression unemployment rose again to 20 percent and there was a mild decline in the price level in 1938 and 1939.

II. Theoretical and Policy Problems Posed by Stagflation

The coexistence of substantial unemployment and rising price and wage levels is a puzzling phenomenon for the economic theorist and it confronts economic policy, and more precisely macroeconomic ("Keynesian") policies of demand management, with a nasty dilemma.

The theoretical puzzle is well expressed by the repeated rueful complaints by Arthur Burns that the economy does not seem to behave as it used to. How is it possible that in the face of substantial unemployment and excess capacity—in other words, that despite excess supply in labor and commodity markets—wages and prices continue to rise sharply? The answer is that in an ideal fully competitive economy stagflation would be impossible and that in moderately competitive economies as we had them in the not too distant past stagflation would be mild and confined to short periods.

The policy dilemma of stagflation is this: If macroeconomic monetary and fiscal policies try to counteract inflation, they increase unemployment; if they try to reduce unemployment they intensify inflation. In the "classical" recessions (depressions) and booms of the past the dilemma did not exist or existed only to a small extent and in an ideal competitive economy there would be no such dilemma. The policy conclusion is obvious: To eliminate the dilemma or to reduce it to more tolerable proportions, the economy must be made more competitive by removing at least the most serious restraints and restrictions on free competitive markets.

The crucial importance of the fact that the economy has increasingly deviated from the competitive ideal can perhaps be most clearly demonstrated if we analyze the impact of the so-called "special factors" on inflation, recession, and stagflation under alternative assumptions about the competitive structure of the economy.

Let us take as an example the enormous rise in the oil price decreed by OPEC. First, let us ask how an ideal fully competitive economy would react to a levy (deterioration in the terms of trade) imposed by the foreign oil cartel. If the price of oil (and of oil-related products) were forced up and the price level were to remain stable other prices would have to decline. If full employment were to be preserved, this would require that money wages

(more generally, money incomes) go down. In an ideal competitive economy where wages were flexible downward (as well as upward) a suitably tight monetary policy would bring about the necessary wage and price adjustments without creating more than temporary, frictional unemployment.[(2)] The resulting decline in *real* wages would reflect the unavoidable decline in real national income.

Second, let us assume money wages to be entirely rigid downward—a quite realistic assumption indeed. In that case, keeping the price level stable by monetary policy would cause unemployment(a recession). That is what Arthur Burns told Congress; the Federal Reserve System, he said, could have prevented inflation, despite the oil price rise, but only by forcing down other prices and thereby creating an intolerable amount of unemployment. It was therefore necessary to allow prices to rise in order to bring about the unavoidable reduction in *real* wages by inflation. The argument is unexceptionable.[(3)] But it should be observed that with wages rigid downward (without any wage-push upward) the rise in the price of imported oil, representing a burden of about $20 to $22 billion for the $1.5 trillion U.S. economy, would merely cause a once-for-all price rise of about 1.4 percent. In other words, only a small fraction of the inflation that actually occurred from 1973 to 1975 could be explained—and justified—in this manner. To say that only a small degree of inflation can be "justified" merely means that with rigid money wages the oil price rise would create some unemployment if the price level were kept stable. It is not intended to prejudge the question whether the inflationary reaction to the oil price rise would reduce the *real* burden of the oil price rise—something which depends on the reaction of OPEC. If the nominal price of oil (in dollar terms) remained unchanged,

(2) For our purposes it is not necessary to discuss how the money supply would have to be managed to keep the price level stable.

(3) It is in effect an application of the theorem formulated by F.A. Hayek and Charles Schultze that says downward wage rigidity (even without any wage push upward) is inflationary as a consequence of *shifts* in demand. Wages and cost of production rise where demand has increased, but fail to decline where demand has decreased. See F. A. Hayek, "Inflation from Downward Inflexibility of Wages" in ***Problems of U.S. Economic Development***, ed. by Committee for Economic Development (CED), New York, The Committee, 1958, Vol. 1, pp.147-52. Reprinted in F.A. Hayek, ***Studies in Philosophy, Politics and Economics***, Chicago, University of Chicago Press, 1967, and Charles L. Schultze, ***Recent Inflation in the United States***, Study Paper No. 1, Joint Economic Committee, 86th Congress, 1st session, Washington, September 1959.

the *real* burden of the oil price rise would be reduced by inflation in the importing countries, because the terms of trade would be better than they would be if the importing countries kept the price level stable. But it is probably realistic to assume that OPEC would react by raising the nominal price of oil so as to keep the real price at some preassigned level.

It is true, there were other "special factors" at work (there always are): the rise in domestic energy prices, the Russian wheat sale, a moderate crop shortfall not to mention the temporary disappearance of the anchovies from the Peruvian coast, a disappearance that caused a. sharp rise in soybean prices. The result of all these changes was an *internal* income transfer from the urban sector to energy producers and farmers. This, in turn, had an inflationary impact through the Hayek-Schultze effect. But all special factors combined in conjunction with money wage rigidity can explain only a fraction (perhaps a fourth) of the two-digit inflation. The comparative unimportance of the special factors in the inflation picture has been acknowledged by Arthur Burns. In a recent speech he said: "The truth is that, for many years now, the economies of the United States and many other countries have developed a serious underlying bias toward inflation. This tendency has simply been magnified by the special influences that occasionally arise —such as a crop shortfall that results in higher farm prices, or the action of a foreign cartel that raises oil prices."[4]

Third, downward rigidity of money wages is unfortunately not the only nor the most important present deviation from the competitive ideal. As William Fellner, Friedrich Hayek, and others have pointed out, labor unions, like everyone else, have become "inflation conscious"—in other words, money illusion has largely disappeared and "real wage resistance" (in the phrase of Sir John Hicks) has developed. The same is true of other pressure groups that manage by political means to force the government to raise the price of their products and the incomes of their members. Organized agriculture is the best and most important example. The resistance to real-income reductions finds its expression in aggressive wage contract bargaining and widespread indexation. Furthermore, labor unions and other pressure groups are in general not satisfied with preserving their real incomes but wish to

(4) Speech at the University of Georgia, Athens, Georgia, September 19, 1975, reproduced from typescript.

increase them. The recent wage contract won by the teamsters' union under pressure of a nationwide strike in an election year is a perfect example. It provides for a substantial (10 percent) annual increase in money wages for the next three years plus full indexation. The precise magnitude of the real wage increase is not quite clear. But there can be no doubt that the terms of the contract greatly exceed the annual increase in overall productivity and that the contract must, therefore, be judged to be highly inflationary. If, under these circumstances, an attempt is made to hold the lid on inflation by monetary restraint, unemployment develops. This is stagflation.

Enough has been said to make clear that in an ideal, fully, competitive market economy stagflation would be impossible. The spectacle of wages rising rapidly in the face of heavy unemployment, both overall and in particular industry, could not be seen in a free-market economy.

But why has stagflation suddenly reached such a high level in 1974—1975? There has been no sudden burst but rather a gradual (though since the 1930s rapidly accelerating) rise in restrictions on the competitive market economy. The answer is to be found in the inflationary history of the post-war period. Prolonged inflation, whatever its origin, was bound to erode money illusion and to generate inflationary expectations. If most people expect an inflation of (say) 15 percent and the actual rate is then reduced to 7 or 8 percent, losses, retrenchment and some unemployment must be expected even in a much more competitive economy than the one we actually have. But it is still true that the resulting stagflation, unemployment, and slack would never have become so serious and intractable if so many restrictions, rigidities, and deviations from the competitive ideal had not piled up over the years, (especially since the 1930s).

How about the monetary factor? The monetarists are, of course, right that stagflation, like any other kind of inflation, is a monetary phenomenon in the sense that it would be impossible without monetary growth. But we must keep in mind that what monetarists have established is a close relationship between monetary growth and the growth of *money* GNP. The relationship between monetary growth and *real* GNP is a different matter. In the words of a prominent monetarist "we still know very little about the division of short-run changes in nominal GNP between changes in output, on the one hand, and changes in prices, on the other. This is a deficiency

of both the Keynesian and the monetarist analyses."[5] It is true that macroeconomic theories of the monetairist or Keynesian type cannot tell us how a change in money GNP will be divided between price change and quantity change. To solve that problem microeconomic considerations are needed. But Meiselman underestimates what we know about that problem. In particular he is much too pessimistic when he says that we do not know why the recovery after 1933 was so slow and why the "revival was aborted in 1937."[6] I find Milton Friedman's microeconomic explanation of "why [in 1933 to 1937] so large a part of the growth in nominal national income was absorbed by prices" entirely convincing. It was "the cost puch" he said, from the "NIRA, AAA, Wagner Labor Act and the associated growth of union strength" that was responsible.[7] In 1937 the alarming price rise induced the Federal Reserve System to raise reserve requirements in order to remove excess reserves. This, in turn, led the banks to contract credit and brought on the depression. This explanation should be acceptable for Keynesians as well as for monetarists. Alvin Hansen, for example, was fully aware of the danger that an "increase in aggregate demand [may be] unnecessarily dissipated on higher prices with corresponding less effect on output and employment."[8] And Keynes himself did mention the importance of downward flexibility of *relative* wages, of prices, and of exchange rates for the smooth functioning of the economy and the effectiveness of macropolicies.[9]

There exists a substantial modern literature on the "Microeconomic Foun-

(5) David I. Meiselman in ***Answers to Inflation and Recession: Economic Policies for a Modern Society***, New York, National Industrial Conference Board, 1975, p.23. Friedman, too, notes that the highly aggregated macro-models of the monetarist and Keynesian type have nothing "to say about the factors that determine the proportions in which a change in nominal income will, in the short run, be divided between price change and output change." See Robert J. Gordon, ed., ***Milton Friedman's Monetary Framework: A Debate with His Critics***, Chicago, University of Chicago Press, 1974, pp.49-50 and 135.

(6) Meiselman, ***Answers to Inflation and Recession***, p.23.

(7) Milton Friedman, "What Price Guideposts?" in George P. Shultz and Robert Z. Aliber, eds., ***Guidelines Informal Controls and the Market Place***, Chicago, University of Chicago Press, 1966, p.22.

(8) Alvin H. Hansen, ***A Guide to Keynes***, New York, McGraw-Hill, 1953, p.193.

(9) J.M. Keynes, ***The General Theory of Employment, Interest and Money***, New York, Harcourt, Brace & Co., 1936, p.270.

dations of Employment and Inflation Theory"[10] This theory is essentially one of frictional or structural unemployment, inasmuch as it describes and analyzes in detail the search for suitable jobs on the part of employees who have lost their previous job and the search for suitable candidates for job openings on the part of employers. Stress is laid on the cost (both money and opportunity cost) of gathering information about jobs, including the income foregone by not accepting second- or third-best options that may present themselves. One aim of most contributors to this literature is to explain unemployment without reference to labor unions and money illusion. It is unquestionably true that the picture of a perfectly competitive labor market in which wages immediately adjust to the market-clearing level does not correspond to reality. Even if there were no unions and no money illusion, workers who have lost their jobs would not immediately accept wage cuts in their old employment (if that were an option) or inferior job offers elsewhere. They would take their time and invest time and money to search for acceptable openings. What is true of labor markets is also true of many commodity markets, especially of the market in durable manufactured goods were seller-buyer and manufacturer-customer relationships are important. In these markets prices are sticky and respond sluggishly to changes in demand, even in the absence of monopolies and oligopolies. This stickiness implies that in the short run quantity adjustments resulting in ups and downs of employment and of capacity utilization play a great role. All that is well described in Okun's paper.[11]

This analysis of frictional or structural unemployment is an extremely useful exercise. It has greatly enriched our knowledge of the way the economy works. The perfectly competitive economy in which all prices and wages immediately adjust to any change in the data and in which markets are cleared continuously at the full-employment level is an ideal never fully realized—even in the absence of monopolies or oligopolies in commodity and labor markets.

(10) See especially a volume of essays under that title edited by Edward S. Phelps, New York, W.W. Norton, 1970. See also the interesting article by Arthur Okun, "Inflation: Its Mechanics and Welfare Costs," in *Brookings Papers on Economic Activity*, 1975 (2), pp.351-90.

(11) Okun, "Inflation: Its Mechanics and Welfare Costs." Sir John Hicks, too, has stressed the difference between what he calls the "fixprice" and "flexprice" sectors of the economy. See his booklet *The Crisis of of Keynesian Economics*, Oxford, Clarendon Press, 1974, passim.

What I find unfortunate and unacceptable is the tendency in that literature to obliterate the distinction between general depression or recession unemployment (often called Keynesian unemployment) on the one hand and frictional or structural unemployment on the other hand, to play down the importance of labor unions, to ignore the fact that unions have made money wages almost completely rigid downward, to neglect the inflationary implications of the fact that the unions often push up wages even in the face of heavy unemployment.

I find equally unconvincing the reinterpretation of Keynes's theory of involuntary unemployment. It runs as follows: Unemployment is the "consequence of a decline in demand when traders do not have perfect information on what the new market-clearing price will be. No other assumption .... needs to be relinquished... in order to get from the Classical to Keynes' Theory of Markets."(12) If, as Keynes says, workers do not accept a reduction of their real wage when it comes in the form of a reduction of their money wage, while they do accept it in the form of a rise in prices, it is not because unions rule out money wage reductions or because of money illusion. The real reason is said to be different: A rise in the price level "conveys" the information that "money wages everywhere have fallen relative to prices." Workers reject an equal cut in their real wage in the form of a money wage reduction because "a cut in one's own money wage does not imply that options elsewhere have fallen."(13) Tobin offers the same interpretation of Keynes's theory of involuntary unemployment. "Rigidities of money wages can be explained by workers' preoccupation with relative wages and the absence of any central economy-wide mechanism for altering all money wages together."(14)

This interpretation is in my opinion unconvincing. Keynes was confronted with the mass unemployment and misery of the 1930s; he surely did not want to say that workers were unemployed (more or less voluntarily) because they were shopping around for better opportunities or that they were "preoccupied" not so much with their own plight as with the possibility that if

(12) Axel Leijonhufvud, *On Keynesian Economics and the Economics of Keynes*, London and New York, Oxford University Press, 1968, p.38.

(13) Armen A. Alchian, "Information Costs, Pricng and Resource Unemployment," in *Microeconomic Foundations of Employment and Inflation Theory*, ed. by E. Phelps, p.44.

(14) James Tobin, "Inflation and Unemployment," *American Economic Review*, March 1972, p.5.

they accepted a lower money wage other groups might get away with a better bargain. Keynes was, of course, opposed to *general* wage reduction as a recovery measure. But even at that time few economists favored that policy.[(15)]

The upshot of this discussion is that the literature on the microfoundations of inflation and employment theory is of little help for explaning the stagflation dilemma, because it abstracts from the most important factors—wage rigidity, wage push, real wage resistance from labor unions, similar activities of other pressure groups, and the effect of the widespread government regulation of industries. I find Frank H. Knight's explanation much more convincing. With the Great Depression in mind Knight wrote in 1941: "In a free market these changes [in demand and prices of different types of goods] would be temporary, but even then they might be serious; and with important markets as unfree as they actually are... the results take on the pro-

(15) It is true, there can be found passages in *The General Theory* which suggest that Keynes held the theory criticized here. On p.264 for example he wrote: "since there is, as a rule, no means of securing a simultaneous and equal reduction of money wages in all industries, it is in the interest of all workers to resist a reduction in their own particular case." This could be interpreted to mean that workers were primarily interested in relative wages. True, no one wants to be discriminated against, and the invisible hand of free competition would bring about equal pay for equal work and eliminate any discrimination. But the process of competition requires that the price be bid down when there is excess supply. To say that despite the heavy unemployment, wage reductions are refused because workers are primarily concerned with relative wages—in other words, because they are unwilling to work at a lower wage than that of workers in some other industries—implies that the individual workers who become unemployed (as distinguished from their unions) prefer a zero-wage to a posive wage. That is not a plausibie behavior assumption and it is difficult to believe that Keynes meant to make it. The situation is, however, quite different if we drop the assumption of competition and instead assume collective bargaining through a union. For a union it is perfectly rational to accept a certain amount of unemployment, provided the total wage (of those employed and those unemployed) is greater than under full employment. Obviously, generous unemployment benefits will make it much easier for the unions to solve the difficult problem of sharing the burden of unemployment among their members and thus will induce the unions to accept a larger amount of unemployment than they would otherwise accept.

In the next sentence after the one quoted above Keynes makes it clear that he was thinking of general wage cutting: "In fact, a movement by employers to revise money-wage bargains downward will be much more strongly resisted, than a gradual and automatic lowering of real wages as a result of rising prices." There can hardly be a quarrel with that proposition up to the point where money illusion has been fully eroded by prolonged inflation and real wage resistance and real wage push have developed. That point marks *The Crisis of Keynesian Economics* of which Hicks speaks (see footnote 11 above). As was noted earlier, Keynes favored changes in relative "wages of particular industries so as to expedite transfers from those which are relatively declining to those which are relatively expanding," *The General Theory*, p.270.

portion of a social disaster."[16] Since 1941 the economy has moved much farther away from the competitive ideal. There are many more powerful unions—for example public employees (including not only bus drivers, subway personnel, garbage men but also teachers, civil servants, firemen, policemen) are now unionized and do not hesitate to use the strike weapon to push up their wages. Many other pressure groups have organized the mselves and government regulation of more and more and industries has made more prices rigid downward while they remain elastic upward. In addition the public sector has grown enormously—which is bound to slow GNP growth.[17] Slower growth of aggregate supply collides with ever increasing claims on the available national product. This puts heavy pressure on the monetary authorities to make a choice between giving way and financing an inflation or standing firm and bringing on a recession. Monetarists are right when they say that stagflation like any other type of inflation cannot be stopped without an appropriate monetary policy. Monetary restraint is a necessary condition for stopping an inflation but it is not a sufficient condition for an economically efficient and politically feasible anti-stagflation policy. I agree with William Fellner, Herbert Giersch, Friedrich Hayek, Hendrik S. Houthakker[18] and

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(16) F.H.Knight, "The Business Cycle, Interest and Money," reprinted from *Review of Economics and Statistics*, Vol. 23, No. 2, May 1941, in F.H. Knight, *On the History and Methods of Economics*, Chicago, University of Chicago Press, 1956, p.335.

(17) This ominous development has gone farthest in Great Britain. *The Economist* of London recently, November 15, 1975, p.18 reported about a study by two Oxford economists (Robert Bacon and Walter Eltis) which reaches the conclusion that "Britain's [economic] disaster in the past decade.... has been that.... in 1961—1973 the numbers of men employed in industry fell by 14%.... The emigration has been into the public sector employment, where the marginal productivity of labor is often tiny or nil, with a.... 53% increase in local government employment.... and a 14% increase in central government employment." The study by Bacon and Eltis was summarized in three articles in the *Sunday Times* (London), November 2, 9, and 16, 1975, and will be published in full by Macmillan (London) later this year.

The same alarming development threatens Italy. Guido Carli, the former governor of the Italian National Bank, has warned that the government deficits in Italy have now grown beyond the capacity of the economy to absorb them, crushing the economy and cutting living standards. These deficits result from the growth of the bureaucracy, generous social security and health insurance payments, liberal unemployment benefits, and the massive cost of what Carli calls "concealed unemployment"—that is, in many industries workers produce goods, at public expense, for which there is no demand. (See *New York Times*, December 9, 1975.) The United States is rapidly moving in the same direction. See Warren Nutter, *Where Are We Headed?*, AEI Reprint No. 34, Washington, D.C., American Enterprise Institute, 1976.

(18) William Feller, "Lessons from the Failure of Demand-Management Policies: A Look at the Theoretical Foundations," *Journal of Economic Literature*, Vol. 14, No. 1, March 1976, pp.34-53, Herbert Giersch, "Some Neglected Aspects of Inflation in the World Economy,"

others that a tight monetary and fiscal policy must be supplemented by measures designed to make the economy more competitive. If we rely on monetary and fiscal restraints alone, we will create so much unemployment that the fight against inflation will be broken off prematurely. This premature breaking off has in fact taken place in country after country. The result will be more inflation and more unemployment, a stop-and-go cycle around a steepening price trend. The great danger is that the cry for comprehensive wage and price controls will become irresistible despite the dismal failure of controls whenever and wherever they have been tried. Since the people will remember from the last time how to anticipate and evade the controls, the next time around the system of controls will run its course rapidly: that is, it will break down, merely disrupting the economy, or (perhaps more likely) will be quickly followed by consumer rationing and allocation, leading straight into a fully planned and regimented economy.

III. Structural Reform or How to Make the Economy More Flexible and Competitive

In recent years government policies and regulations that restrain competition, protect (or even create) private monopolies, restrict production, and raise or fix prices have come under closer scrutiny. Economists have unearthed and described dozens of such cases.(19) Phasing out these restrictions and changing these policies would go a long way toward making the economy more competitive and flexible than it is now, thus making macroeconomic

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Public Finance, The Hague, 1973, esp. pp.104-08, F.A. Hayek, "Unions, Inflation and Profits," *Studies in Philosophy, Politics and Economics*, Chicago, University of Chicago Press, 1967, and "Inflation, the Path to Unemployment," *Inflation: Causes, Consequences, and Cures*, London, Institute of Economic Affairs, 1974, "Zwölf Thesen zur Inflationsbekämpfung," *Frankfurter Allgemeine Zeitung*, August 19, 1974. Hendrik S. Houthakker, "Incomes Policies as a Supplementary Tool" in *Answers to Inflation and Recession: Economic Policies for a Modern Society*, New York, The Conference Board, 1975. The title of Houthakker's speech is misleading. He argues that price and wage controls and incomes policies (in the conventional sense) can make only an "extremely modest contribution." His thesis is that macroeconomic policies must be supplemented by "structural reform."

(19) See for example Hendrik S. Houthakker, "Specific Reform Measures for the United States," in *Answers to Inflation*, pp. 83-85; Murray L. Weidenbaum, *Government-Mandated Price Increases: A Neglected Aspect of Inflation*, Washington, D.C., American Enterprise Institute, 1975, and numerous other AEI publications, and *Annual Report of the Council of Economic Advisers*, 1975, Chapter 5, "Government Regulations."

recovery and anti-inflation policies more effective. Here only a few examples can be mentioned.

In the field of agriculture, although output restrictions on some basic foodstuffs were belatedly lifted after food prices had exploded in 1973 and 1974, such restrictions still exist on several important products. Furthermore, interregional trade in many agricultural commodities (especially dairy products, fruits, and vegetables) is severely restricted by federal and state marketing orders or by producers privately organized—organizations in restraint of trade that are government-sponsored, government-licensed, government-enforced, and of course exempt from antitrust laws. Imports of many agricultural products from abroad, especially of meats and fruits, are sharply restricted. Such policies freeze and distort prices and reduce output because they prevent a rational interregional and international division of labor. There exist, furthermore, many import restrictions on industrial products, apart from tariffs, including the so-called "voluntary restrictions" imposed on foreign exporters, ranging from exporters of steel to exporters of textiles. These "voluntary" restictions are especially damaging and costly because they force foreign producers to organize themselves in export monopolies at the expense of the American consumers. There is, furthermore, the Buy American Act which prevents foreign competition and costs the U.S. taxpayer many hundreds of millions of dollars. The field of transportation and energy is full of government-imposed restrictions on competition.[20]

Most difficult to deal with, but crucially important, are restrictions in the labor market imposed by labor unions. The importance of unions has been often questioned on the ground that in the United States only 20-25 percent of the labor force is unionized. But it has been demonstrated many times that, for various reasons that need not be repeated here, nonunion wages tend to follow union wages although at a distance and usually with a lag.[21] Leaving aside far-reaching structural reforms of the present methods of wage determination by industry-wide collective bargaining under the constant threat of crippling strikes, there exist a number of policy changes that could reduce wage pressure, increase competition, and expand output and employ-

(20) See especially the CEA report for 1975, Chapter 5, and numerous AEI publications.

(21) See, for example, Gottfried Haberler, *Economic Growth and Stability*, Los Angeles, Nash 1974, p.107.

ment. Houthakker mentions the following: "Unions should be prevented from restricting membership by apprenticeship requirements, nomination procedures, or excessive entrance fees; nor should they be allowed to operate hiring halls. The Davis-Bacon Act and similar laws requiring excessive wages to be paid under government contracts have interfered seriously with the performance of the construction market [and cost the taxpayer hundreds of millions of dollars]; they should be phased out not only at the federal but also at the state level."(22) Today, moreover, the government finances strikes by generous unemployment benefits and welfare payments. In some states such benefits go even to the strikers themselves, and in that connection a proposal of Arthur Burns should be mentioned. In an important speech he has recommended that "public employment" be offered to anyone who is willing to work at a rate of pay somewhat below the Federal minimum wage." Burns stressed that a low rate of pay in such public service employment is essential to prevent "such a program from becoming a vehicle for expanding public jobs at the expense of private industry."(23) Public service employment would largely take the place of the present system of unemployment benefits which have become so generous that they "blunt incentives to work."(24) It has been found that in many cases unemployment benefits and various welfare grants (all of which are tax-free) exceed the income after taxes that a person could earn if he accepted a job for which he was qualified.

Minimum wage laws cause considerable unemployment among teenagers and other underprivileged groups, especially blacks and high-school dropouts. The minimum wage laws deprive thousands of young people of their first crucial on-the-job training and may seriously damage their whole future working career. These laws are a social and economic crime and should be phased out.(25) Unions strenuously object to the phasing out of minmum

(22) Houthakker, "Specific Reform Measures for the United States," pp.83-85.

(23) Speech at the University of Georgia, Athens, Georgia, September 19, 1975, reproduced from typescript. Britain's economic disaster in the past decade, which was mentioned in footnote 17 to this paper, should serve as a warning not to expand employment without proper safeguards.

(24) *Ibid.*

(25) Actually there is a strong movement in Congress to raise the minimum wage from $2.30 to $3.00 an hour and henceforth to adjust it automatically for any rise in the consumer price index (indexation). This measure would sharply reduce job opportunities for teenagers and

wage legislation. They even reject a reduction of the minimum wage for teenagers on the grounds that such a change would give employment to some teenagers at the expense of adult workers; "sons would displace their fathers on the jobs." This argument completely misses the purpose of policies designed to make the economy more competitive and flexible. Such structural reform is not a zero-sum game: The purpose is not a redistribution of a given pie but the enlargement of the pie. Overall employment and output would increase, and so would real wages, partly because more expansionary and more effective monetary and fiscal policies would be possible if the threat of rekindling inflation were eliminated (or at least sharply reduced) by measures that would make the economy more competitive and flexible.

What about incomes policy? A policy along the lines indicated above, designed to make the economy more competitive, is sometimes called an "incomes policy." Arthur Burns has used that terminology. In earlier publications I have called it "incomes policy II" as distinguished from incomes policy I in the usual sense of wage and price guidelines, price stops, wage freezes, and similar measures. Because of these connotations of the term incomes policy, it is perhaps better not to use it for the policy here recommended.

Keynesians and monetarists alike should be able to agree on the desirability of structural reform for the purpose of making the economy more competitive and more flexible. The Keynesian (or, more precisely, the Phillips-curve advocate) would say that such a reform would improve the terms of the trade-off between unemployment and inflation, while the monetarist would assert that the reform would reduce the level of "natural" unemployment.[26]

IV. Concluding Remarks

I am painfully aware that structural reform along the lines sketched here

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other underprivileged persons, it would magnify and perpetuate, even in boom times, unemployment among such groups and would accentuate the inflation.

(26) Such an agreement would not compel the two groups to forego the pleasure of continuing their quarrels, the monetarist insisting that the trade off cannot be permanent and the Keynesian objecting that the "natural" level of unemployment will never be reached.

will be at best a very slow process. Vested interests fiercely resist any attempt at deregulation and liberalization and the beneficiaries of present policies hold on, tooth and nail, to their privileges and monopoly positions. What, then, are the policy options if quick relief through structural reform is beyond our grasp?

There is, I believe, no other choice but to continue the present policy of letting the economic expansion proceed slowly in the hope that inflation will not accelerate too rapidly. In my opinion it would be a great mistake to speed up the expansion in order to reduce unemployment quickly, whatever the political appeal of such a policy may be in an election year. Quick expansion surely would speed up the ongoing inflation. The consequence would be either that the monetary brake would be applied and the expansion give way to a new inflationary recession or (perhaps more likely) that the call for wage and price controls would become so strong that the system of controls would be tried once more despite the dismal failure of earlier attempts. The controls would either soon become ineffective, merely further disrupting the economy and burdening it with a new bureaucracy without preventing a recession, or worse (but perhaps more likely) lead to consumer rationing, compulsory allocation of factors of production, and full regimentation of the economy in the guise of economic planning.

The many Keynesians who argue that large unemployment and slack in the economy make a quick expansion safe at present forget that the experiment has been made: much unemployment and slack has *not* prevented the rapid inflation of the last three years. (The operation of "special" inflationary factors can, as we have seen, "explain" only a fraction of the price rise that has occurred.) To say as some do that a more rapid monetary expansion would reduce the rate of inflation because it would stimulate production and so increase aggregate supply is like saying that one can make a drunk sober by forcing whiskey down his throat to pep him up. True, if the poison is withdrawn from him too rapidly a situation may arise where one must increase the dose of the stimulant temporarily to forestall an imminent collapse. But I do not believe that the economy faces that danger now. The economic recovery that started a year ago has gathered momentum and is likely to continue for a considerable period without any additional monetary or fiscal stimulation.